VZCZCXRO1587
PP RUEHDBU RUEHFL RUEHKW RUEHLA RUEHNP RUEHROV RUEHSL RUEHSR
DE RUEHBM #0563/01 2251437
ZNY CCCCC ZZH
P 131437Z AUG 09
FM AMEMBASSY BUCHAREST
TO RUEHC/SECSTATE WASHDC PRIORITY 9819
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RHEHNSC/NSC WASHDC PRIORITY

C O N F I D E N T I A L SECTION 01 OF 03 BUCHAREST 000563

SIPDIS

STATE FOR EUR/CE ASCHIEBE AND AMB. GITENSTEIN
TREASURY FOR LKOHLER AND JBAKER

E.O. 12958: DECL: 08/12/2019
TAGS: EFIN ECON ETRD EIND PGOV IMF EUN RO
SUBJECT: ROMANIA AND IMF: REVISE AGREEMENT AS THE ECONOMY WORSENS

REF: BUCHAREST 424 AND PREVIOUS

Classified By: Charge d'Affaires, a.i. Jeri Guthrie-Corn for reasons 1.4 (b) and (d).

¶1. (C) Summary. Romania's economy is contracting at a much faster pace in 2009 than originally forecast and its agreement with the International Monetary Fund (IMF) requires important modifications as a result, an IMF monitoring team announced on August 10. Concluding their first quarterly review of Romania under the agreement reached last spring (reftels), the IMF said GDP would shrink by 8.0 to 8.5 percent this year, at least double the 4.0 percent decline predicted just a few months ago. In a meeting with the Acting DCM immediately following the team's visit, IMF Resident Representative Tonny Lybek provided a first hand analysis of the "staff level" agreement that the team had negotiated with the Government of Romania (GOR). The agreement is noteworthy because it will allow IMF funds to be used directly to cover the Government's yawning budget deficit. In return, the IMF is requiring that the GOR cut spending by 0.8 percent of GDP before year's end and push through structural reforms to include a new unified public sector wage structure, fiscal management reform including tighter control over local government spending, and changes to the retirement pension system. While both of the political parties in the governing coalition assured the IMF team that they are committed to the deal, the terms of the revised agreement are a signal that the IMF program is entering its most painful and politically dicey phase. End Summary.

¶2. (SBU) According to the IMF, the Romanian economy is on track to contract by more than eight percent in 2009 due to a "very tough external environment" in Romania's main export markets, a collapse in domestic production, and an accelerating decline in consumption. Latest GOR figures show a drop of 7.6 percent in the first half of the year compared to the same period in 2008, with an only slight moderation in the rate of decline seen for the remainder of the year. Officially, the IMF team predicted an 8-8.5 percent contraction, but Lybek believes it could go as deep as nine percent. This shrinking economy has blown a hole in the GOR's budget, with an expected deficit of 7.3 percent of GDP for the year provided that the GOR slashes spending by 0.8 percent in accordance with the IMF program. This is a tall order, considering that the GOR must now cut spending in the last four months of 2009 by nearly the same amount it had originally committed to cut for the entire year.

¶3. (C) Despite the gloomy numbers, the IMF is predicting (hoping) that this is as bad as it gets, and that Romanian GDP will post very modest positive growth in 2010. The only bright spot in the forecast is the rapid turnaround in the

twin demons -- inflation and a high current account deficit -- which had plagued Romania during its recent economic boom. Inflation is expected to fall to 4.3 percent for the year, while the current account deficit has fallen faster than expected to 5.5 percent of GDP from over 12 percent in 2008. In Lybek's view, Romania may even outperform the program's inflation targets. The IMF asserts that the GOR should get credit for meeting its budget targets for the first three months of the original program, noting that the steeper-than-expected downturn and its effect on GOR revenues have forced a program revision. Lybek did acknowledge, however, that spending reductions so far had largely been achieved through temporary measures -- such as delaying VAT reimbursements, curtailing government travel, and suspending new equipment purchases -- which contribute little to long-term cost savings.

¶4. (SBU) The most notable revisions to the IMF program targets are an increase in the allowed budget deficit, from 4.6 to 7.3 percent of GDP in 2009 and from three percent to just under six percent in 2010, accompanied by additional GOR budget cuts equivalent to 0.8 percent of GDP by the end of 2009 and 2-2.5 percent more in 2010. To help ease the pain, the IMF will allow roughly half (or about $1.9 billion) of its next two tranche disbursements to Romania to be diverted to the budget rather than added to the National Bank of Romania's (BNR) foreign currency reserves as originally planned - a diversion which Lybek confessed is "very unusual" under IMF practices. The IMF is worried that the amount of GOR borrowing that would be needed to fully finance the 7.3 percent deficit would crowd out domestic lending to the private sector at a time when domestic bank lending generally

remains extremely tight. Direct budgetary support will mitigate the downside risk of excessive government borrowing, which could further choke an eventual economic recovery.

¶5. (SBU) Despite his concern about high levels of GOR borrowing, Lybek was relatively sanguine about the health of the financial sector and the amount of liquidity available. To date the financial sector has experienced no bank failures, and the nine largest banks in Romania have renewed their pledge to the IMF to keep capital in the country as the BNR gradually relaxes reserve requirements. While the IMF believes that continued GOR borrowing will eventually start to "vacuum up" available liquidity, Lybek does not believe that this is the case so far. He noted that interbank rates have been falling and are currently close to policy rates. Business complaints about the lack of credit can be attributed as much to the recession as GOR borrowing, according to Lybek. The IMF support to the GOR will be accompanied by recommendations that the GOR work to increase the maturities on bonds and consider a Eurobond issuance, something the GOR has already announced it is preparing to do later in the fall.

¶6. (C) Structural reforms have been a part of the IMF package from the beginning, but the steep downturn has made their completion a matter of urgency if Romania is ever to return to fiscal sustainability. Reform of public sector wages through standardized rates across all parts of the GOR, increased transparency, and a reduction in bonuses and non-salary compensation remains the centerpiece of reforms the IMF is requiring. Lybek said the Government remains on track to complete a draft wage law in October and that the IMF was pleased with the provisions of the draft so far. Improved fiscal management remains a critical area for long-term improvement. Lybek is particularly focused on improved tax collection as an opportunity for the GOR to raise funds to close the budget deficit. To this end, a team of tax experts visited Romania last month and provided a series of recommendations to the GOR, many of which can be implemented without legislative changes. (Comment: In post's view, "improved tax collection" is a double-edged sword, given the GOR's demonstrated proclivity to focus

intrusive tax audits on easy, high-profile targets such as multinational investor companies. End comment.)

¶7. (C) A major new area of IMF concern is the fiscal management of local governments, which are major employers and spenders but which currently have very limited taxation powers and are almost exclusively dependent on central government transfers for funding. Romania has no systematic methodology for allocating these funds, and there is little control over how the money is spent once it leaves the GOR's coffers. The IMF, perhaps a tad nave as to the political firestorm it will induce, correctly believes that this is an area ripe for reform and plans to push the GOR to implement structural changes in how local governments operate. Cutting off the money train, however, will likely raise the ire of regional party bosses, who hold real political power, especially in the Social-Democratic Party (PSD).

¶8. (C) The leitmotif of the IMF monitoring team's visit was missed opportunities, a point that the delegation head, Jeffrey Franks, alluded to in polite but unmistakable terms in his concluding press conference. These include allowing public sector spending to spiral out of control even while tax revenues remained high through Romania's previous economic boom. As a result, there is no cushion remaining to limit the pain of the economic downturn and the very necessary personnel and other cuts that are needed if the GOR is going to remain afloat. Rather than directing tax revenues to capital investments, political expediency, poor planning, and bureaucratic inertia destined most monies toward current consumption. Rather than reforming the pension system, pensions were raised. Loss-making state enterprises were not restructured and sold during the boom years, saddling the GOR with a too-large state sector and structural expenses that it can ill-afford. The worst sin, however, has been the failure to access and spend EU structural funds. It is only now, in the midst of a crisis, that the GOR is getting serious about tapping pre and post-accession funds. Had previous (and current) governments not dithered over the last few years, the Romanian economy would now be receiving a huge boost from the inflow of EU funds instead of finding itself in a serious crunch.

¶9. (C) Comment. The IMF's forecast early this year of a four

percent decline in GDP was dismissed by GOR officials at the time as an excessively gloomy, "worst case" scenario. With the real numbers now twice as bad as even the IMF predicted, all parties accept that the existing program requires major modifications. So far the IMF, in conjunction with the European Commission and World Bank, has correctly identified the most important structural reforms and is pushing the GOR to make them. The next few months, however, will be "crunch time" when the real pain of a shrinking economy will, if the GOR intends to meet its revised commitments, be combined with very disruptive and far-reaching cuts in the public sector. (No sooner had the IMF team left town this week than the GOR began announcing eye-popping personnel reductions, agency consolidations, and furloughs; post will report on these developments septel.) If the IMF is to be faulted, it is for being a tad too trusting of the current government's promises and chances of survival. With a presidential election sucking up most of the political oxygen at the same time that the IMF is prescribing more big budget cuts, the odds increase that Romania's very carefully balanced governing coalition may buckle under the strain. This would put the legislative agenda for enacting the structural reforms the IMF is demanding in serious jeopardy.

¶10. (C) Comment continued. Lybek took pains to emphasize that, as an EU member state, "Romania is not some African country" and that the IMF team was therefore trying hard not to "micromanage" structural reforms. He said the team had agreed to broad targets and was willing to defer to the GOR to determine how to reach them. While post agrees that the

proposed revisions to the standby agreement are probably necessary, the fact of the matter is that the GOR has only stuck to the program so far through substantial budgetary sleight-of-hand -- coupled with a hope that the downturn would not prove too severe and that an early rebound would provide breathing room for the upcoming election season. That hope is gone, and even with direct IMF support for the budget, the adjustments now required will be genuinely difficult and politically costly. End Comment.
GUTHRIE-CORN